

Implementing Inflation Targeting Regimes: The Case of Poland¹

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Poland has recently moved to inflation targeting as a strategy for monetary policy. Such a strategy can best be implemented with some understanding of the linkages between the policy variables and inflation outcomes. This paper finds that the exchange rate played a dominant role as a policy instrument in the 1990's. However, linkages between the short-term interest rate and inflation have been weak. Given this finding, modification of some details of the strategy, such as widening the target range or lengthening the target horizon, would be helpful. *J. Comp. Econ.*, March 2001, 29(1), pp. 24–39. The Kiel Institute of World Economics, 24100 Kiel, Germany; European I Department, International Monetary Fund, 700 19th Street, NW, Washington, DC 20431. © 2001 Academic Press

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1. INTRODUCTION

A number of industrialized economies have adopted inflation targets as a strategy for monetary policy over the past decade, including New Zealand, Canada, the United Kingdom, Sweden, Australia, and Israel.² The apparent success of inflation targeting in these countries has sparked increasing interest from developing and transitional economies. The Czech Republic adopted an inflation targeting regime in early 1998;³ in September 1998, Poland announced its intention of implementing an inflation target from 1999.

Inflation targeting is most likely to be successful with some understanding of the linkages between monetary policy and inflation outcomes. Section 2 reviews the evolution of inflation and monetary policy in Poland since the changes of 1989, outlines the new framework for monetary policy, and considers whether the prerequisites for this framework are in place. Section 3 provides some empirical evidence on the links between the instruments of Polish monetary policy and inflation. Section 4 concludes with an assessment of the new framework.

2. POLISH INFLATION AND MONETARY POLICY IN THE 1990'S

2.1. *Inflation*

Following initial price liberalization in 1989 and the abolition of most price controls with the January 1990 Big Bang reforms, previously repressed inflation emerged strongly. Consumer prices increased by more than 1100% in the year to January 1990. The initial stabilization was successful, bringing inflation back to below 100% by early 1991. The authorities then chose to continue disinflating at a more moderate pace, judging that the costs of further rapid disinflation would have been unacceptably high. Reasons included the weak fiscal position and significant structural rigidities, including widespread indexation. Although Poland made major progress in reducing its large fiscal imbalances by 1993, inflation became entrenched at around 30% for several years.

Relative price adjustment was an important source of inflation through this period (Pujol and Griffiths, 1998).⁴ Inflationary pressures were aggravated by pervasive wage-price indexation and the absence of hard budget constraints on unreformed enterprises.⁵ Although the biggest shifts took place between 1989 and 1991, relative prices continued to adjust through the mid-1990's. Pujol and Griffiths (1998) also found that while the prices of Polish goods were generally

² Finland and Spain also adopted inflation targets prior to European economic and monetary union.

³ Orlowski (1998) considers the early experience with the Czech inflation targeting regime.

⁴ Wozniak (1998) stresses the role of increases in administered prices in driving relative price adjustment and the inflationary process.

⁵ Coorey et al. (1998) discuss the importance of relative price adjustment in the inflation process in 21 transition economies. They argue that the trade-off between growth and inflation worsens when relative price changes are important.

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